No. 7739

In the United States Circuit Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

THE BANK OF CALIFORNIA, NATIONAL ASSOCIATION, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE PETITIONER

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FILED

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OPINION BELOW

The only previous opinion in this case is the opinion of the Board of Tax Appeals (R. 32–44), reported in 30 B. T. A. 556.

JURISDICTION

This petition for review involves income taxes for 1928 and 1929 in the amount of $2,439.76 and $1,620.52, respectively (R. 33), and is taken from the decision entered July 23, 1934 (R. 44–45). The case is brought to this Court by a petition for review filed October 9, 1934 (R. 45–52), pursuant

to the provisions of Sections 1001–1003 of the Revenue Act of 1926, c. 27, 44 Stat. 9, as amended by Section 1101 of the Revenue Act of 1932, c. 209, 47 Stat. 169.

QUESTION PRESENTED

Whether or not the taxpayer should include as taxable income interest received by it in 1928 and 1929 on tax-exempt securities which were subject in its hands to repurchase agreements given simultaneously with bills of sale conveying these securities when turned over to the taxpayer.

STATUTE INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

> SEC. 21. NET INCOME.
>
> "Net income" means the gross income computed under section 22, less the deductions allowed by section 23.
>
> SEC. 22. GROSS INCOME.
>
> (a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from * * * interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.
>
> (b) *Exclusions from gross income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:
>
> *   *   *   *   *

(4) *Tax-Free Interest.*—Interest upon (A) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (B) securities issued under the provisions of the Federal Farm Loan Act, or under the provisions of such Act as amended; or (C) the obligations of the United States or its possessions. Every person owning any of the obligations or securities enumerated in clause (A), (B), or (C) shall, in the return required by this title, submit a statement showing the number and amount of such obligations and securities owned by him and the income received therefrom, in such form and with such information as the Commissioner may require. * * *

STATEMENT

The facts as found by the Board of Tax Appeals (R. 33–37, 43) are as follows:

The respondent is a national banking association, organized and existing under the National Bank Act of the United States, with its principal banking office in San Francisco, California (R. 33).

During 1928 and 1929 the respondent purchased from R. H. Moulton & Company and other investment dealers certain tax-exempt, state, Federal, and municipal bonds and obligations of other political subdivisions. The purchases were made either upon the application of the investment bankers, who held or had commitments for large blocks of bonds which they could not carry themselves, or upon

the request of the respondent, which had available surplus funds desirable for use in obtaining short-term investments. The purchase price was based on, but usually under, the market price plus accrued interest to the date of sale at the coupon rate. Upon the payment of the agreed price, the securities were delivered to the respondent under a bill or memorandum of sale (R. 33). Simultaneously, the respondent and the "seller" entered into the following standard form of agreement, the blanks being filled in to constitute a typical case (R. 34–35):

REPURCHASE AGREEMENT

THE BANK OF CALIFORNIA, N. A., San Francisco, California, a National Banking Association, hereinafter termed "Seller," agrees to sell, and R. H. MOULTON & COMPANY, hereinafter termed "Buyer," agrees to buy the following bonds, namely:

$7,000 CITY OF HANFORD MUNICIPAL IMPROVEMENT 5% BONDS

Numbers and denominations as follows:

$2,000	Aug. 1,	1958,	Nos.	173/74
4,000	"	1961,	"	186/89
1,000	"	1963,	"	199

The purchase price of each bond is as follows (Plus accrued interest):

August 1,	1958	maturity	@ 95
"	1961	"	@ 95
"	1963	"	@ 95

payable in United States gold coin of the present standard of weight and fineness, which sum Buyer hereby agrees to pay on or before ninety days from date hereof. Maturing coupons to be the property of THE BANK OF CALIFORNIA, N. A.

And THE BANK OF CALIFORNIA, N. A., hereby agrees on tender of said purchase price of such bonds and interest as aforesaid to deliver to R. H. MOULTON & COMPANY or its nominee, the bonds as above, at any time hereafter, prior to any default on the part of the Buyer.

It is further understood between the two parties hereto that partial sales and deliveries may be made at the rates stated above.

In the event of any failure on the part of the Buyer to accept and pay for any one or more of said bonds at the time the same is tendered, the Seller shall be released from all obligation in law or equity hereunder and may sell all bonds remaining in its hands without notice and for the best price obtainable, charging the loss, if any, to the account of the Buyer.

Executed in duplicate this 11th day of July 1929.

THE BANK OF CALIFORNIA, N. A.
STUART F. SMITH,
Vice-President.
R. H. MOULTON & COMPANY,
By ELMER BOOTH.

No special conditions other than those set forth in the contracts motivated the actions of the parties

(R. 43). These transactions were entered on the respondent's books as a credit to the seller at the full amount of the purchase price plus accrued interest and were listed and carried in an account called "Bond Account No. 2", to facilitate their expeditious handling. The respondent treated its bonds held under the repurchase agreements exactly as it did all its bonds and other investments. Upon the maturity of a coupon attached to a bond it was collected by the respondent and the proceeds credited to the account "Interest on Investments" on its general ledger. In that account all interest from bonds of whatever nature owned by the respondent was entered. In its call and semiannual statements the bonds subject to repurchase were included in its list of bonds and other investments owned by it. The long-term investments carried by the respondent in its "Bond Account No. 1" and its short-term investments entered in its "Bond Account No. 2" were treated exactly alike from an accounting viewpoint. Likewise, the interest derived from both classes of investments was so treated. The practice was not challenged by the Comptroller of the Currency (R. 35-36).

The sale price set in the repurchase agreement was always exactly the same as the original purchase price. The respondent and the investment dealer adhered strictly to the terms of the repurchase agreement. No supplementary agreement was made to enlarge, modify, or in any way to affect the original agreement or the acts of the parties

thereunder. If the bonds were not repurchased at the expiration of the period named in the agreement no extension was given, but occasionally an entirely new agreement was executed, accompanied by a new bill of sale at a price based on the current market. At times the respondent did not agree to a new contract and the bonds would be repurchased by the dealer and sold to another bank. Often the dealer would repurchase only a portion of the bonds at one time but would continue at intervals to repurchase until all were taken back (R. 36).

The yield to the respondent under the repurchase agreements was less than that received from collateral loans. The respondent often made loans to customers with tax-exempt securities as collateral (R. 37).

The respondent kept its books on the accrual basis (R. 37).

The amount of interest in controversy, aggregating $20,331.40 and $14,731.98, respectively, during the years 1928 and 1929, was computed by adding the amount of the matured coupons actually cashed by the respondent, the amount of the accrued interest received by it upon resale, and the amount of interest accrued on the bonds held by the respondent at the close of the year, and subtracting therefrom the amount of accrued interest paid by the respondent upon the original purchases from the investment dealers (R. 37).

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Other facts in the case which are not covered by the Board's findings, or do not agree with such findings, but which appear in the statement of evidence (R. 54–95) are as follows:

The transactions involving the bonds here were handled by respondent's "note department" (R. 56, 67). The amount of money a national bank can lend a customer is limited by Federal law to ten percent of its capital and surplus (R. 73, 84, 87–88). By using the plan of repurchase agreements, a bank can advance more money to its customers than the law allows it to place on loans (R. 73). The bonds held here were always repurchased by the dealer who turned them over originally to the respondent (R. 75, 81). The price agreed upon for the bonds was "less than the market price, * * * probably one to five percent" (R. 78). R. H. Moulton & Company, the firm which was the dealer here, found it necessary "to borrow substantial sums of money in order to carry these bonds" and found it had to finance its business "through borrowings, or through the sale of the bonds, the temporary sale and repurchase of the bonds" (R. 80). Ninety-nine percent of the dealer's business was done through purchase and repurchase agreements (R. 80). The vice-president of R. H. Moulton & Company stated that the bank was really carrying that dealer's inventory for it (R. 83). "Very frequently these so-called 'sales' to the bank and 'repurchase agreements'

were entered into contemporaneously with the purchase of bonds by R. H. Moulton & Company" (R. 81). If that dealer wanted to purchase bonds and needed money it would sometimes make arrangements with the bank whereby the bonds it purchased could be sold to the bank under an agreement allowing the dealer to repurchase them but there was not always a prior understanding because owing to a more or less constant market for this type of sale and repurchase the dealer could make a commitment on bonds and then arrange with the bank for money (R. 81). If the dealer sold some of these bonds to its customers it would repurchase them from the bank (R. 82), and the bonds which were involved here were carried on the books of R. H. Moulton & Company as assets of that company, and the contingent liability for their repurchase was carried as its liability (R. 91–92).

The Board held that the respondent owned these bonds and that the interest received by it was tax exempt. Accordingly the Board decided that no deficiencies were due for 1928 and 1929 (R. 45).

SPECIFICATION OF ERRORS TO BE URGED

The petitioner's assignments of error (R. 49–51) are incorporated herein fully by reference, but for convenience the assignments are merely summarized here as follows:

The Board of Tax Appeals was in error in holding that the interest received by the taxpayer was exempt from taxation; in failing to hold that the

interest in question was received by the taxpayer on loans to customers; in holding that the securities in question were purchased by the taxpayer; in finding that the taxpayer treated the bonds held under the repurchase agreements as it did all its other bonds; in failing to find that the repurchase agreements were always carried out; in finding that no special conditions other than those set forth in the contracts motivated the actions of the parties; in failing to find that the investment company treated the bonds as its own and that the money for its original purchases was frequently furnished by the taxpayer, and in deciding that there are no deficiencies in tax for 1928 and 1929.

SUMMARY OF ARGUMENT

The Board of Tax Appeals was in error in holding that the respondent was the owner of the bonds here involved during the taxable years and also in deciding that the interest received therefrom was tax exempt. The respondent secured the bonds as the result of transactions called sales but at the same time the parties executed repurchase agreements providing for repurchase by the investment dealer who originally "sold" the bonds. These agreements fixed the price below the market value and at exactly the same figure for the sale to the respondent as for the repurchase by the dealer. They also made the obligation to repurchase absolute. These terms show that the parties did not

intend to make outright sales but merely to make loans with the bonds given as security. This is further indicated by the testimony to the effect that the parties wanted to make loans, but owing to a limitation placed by the National Banking Act on the amount of loans a national bank can make they found it necessary to adopt the plan used here for advancing money.

It is well established that what purports to be a sale on its face may be a mortgage or a pledge and that the intention of the parties should govern. When the intention of the parties here is considered, it is apparent that there were no outright sales to the respondent, and the Board was in error as to the ownership of the bonds. Also, it is clear that the interest which the respondent received was actually the price the original seller paid for loans and that such interest did not become tax exempt in the hands of the respondent merely because paid out of interest due on the bonds. The interest on the bonds would, of course, have been tax exempt in the hands of the owner, the dealer here, but the right to claim the exemption was limited to the latter. So it is immaterial that the dealer agreed to and did discharge its obligation to pay interest to the respondent with the bond interest. The situation is the same as if the dealer had used any other money, for when it came into the hands of the respondent it lost its tax-exempt character.

ARGUMENT

The question in this case relates to the taxability of certain interest received by the respondent during 1928 and 1929, but this in turn depends upon the question of the ownership of the state, Federal, and municipal bonds which are the subject of the memoranda of sale and their contemporaneous repurchase agreements mentioned above.

If these bonds were sold outright to the respondent, then it must be admitted that the respondent was the owner during the taxable years, that the interest came to it as owner of the bonds, and that it can claim the privilege of tax exemption of such interest under the provisions of Section 22 (b) (4) of the Revenue Act of 1928, c. 852, 45 Stat. 791, allowing interest on bonds like those here to be excluded from gross income but requiring the owner thereof to submit a statement as to the income received. The view just summarized represents the position taken by the respondent before the Board of Tax Appeals.

On the other hand, it is our contention that these transactions did not constitute outright sales but were loans, and that the bonds were merely used as security for such loans. Under this view of the case, R. H. Moulton & Company remained the owner of the bonds, the interest therefrom belonged to that company, and it alone can claim the privilege of tax exemption on such income. It would also follow that the relationship of the re-

spondent and R. H. Moulton & Company was that of lender and borrower, that the interest received, although taken from the interest accruing on the bonds, was money which first belonged to the latter company, that pursuant to prior agreements the money was used by that company to pay its obligation for interest to the respondent and so such interest did not come into the respondent's hands as bond interest but rather as interest on loans to a private company. Accordingly, we submit that the interest received here by the respondent comes within the provisions of Section 22 (a) of the Revenue Act of 1928, *supra,* which lists interest as one kind of income to be included in gross income.

It is admitted that the bonds were turned over to the respondent on bills of sale but the true character of the transactions cannot be determined by considering such bills of sale by themselves. This is so because, simultaneously with the giving of the bills of sale, the parties also made repurchase agreements which fixed the repurchase price at the same figure as the sale price and made repurchase an absolute obligation on the part of the original "seller." The terms of these repurchase agreements, together with other evidence in the case (which will be referred to below), make it evident that these transactions were not absolute sales but were in fact loans. Therefore, a consideration of the question here should not be confined to the terms

of the bill of sale or to statements by the witnesses that the bonds were sold. In each instance the repurchase was a part of the same transaction as the sale and so all the facts relating thereto are pertinent, as are also the facts showing the intention of the parties.

While the bills of sale show a sale absolute on their face, we submit that such fact is not determinative of the issue here nor does it preclude a consideration of the other facts in the case just referred to. It is well established that it takes more than the use of the word "sale" or other terminology connected with sales to in fact make a sale. The instrument may be well drawn and apt words used to describe a sale, yet the transaction may in fact be a loan, *Kelter* v. *American Bankers Finance Co.,* 306 Pa. 483. Where there are circumstances which cast doubt on the nature of a transaction, the courts will look beyond the terms of the written instrument. *Kiefer* v. *Myers,* 5 Cal. App. 668, 673.

Indeed, it is now universally held that what purports to be a sale on its face may be a mortgage or a pledge and in deciding the nature of the transaction the intention of the parties should be considered. *Jackson* v. *Lawrence,* 117 U. S. 679, 681; *Peugh* v. *Davis,* 96 U. S. 332, 336; *Russell* v. *Southard,* 12 How. 138, 151; *Whittemore* v. *Fisher,* 132 Ill. 243; *Robinson* v. *Farrelly,* 16 Ala. 472; *Weiseham* v. *Hocker,* 7 Okla. 250. This is also the law in California, where this case arose. *Shelley* v. *Byers,*

73 Cal. App. 44; *Sears* v. *Dickson,* 33 Cal. 326. The case of *Henley* v. *Hotaling,* 41 Cal. 22, which has been frequently relied on to show that the technical language of a conveyance should be upheld and given effect, is distinguished by the *Shelley* case, in which it is pointed out that the intention of the parties should govern and if it is the leading purpose for one of the parties to have a loan, then that should control.

The intention of the parties as expressed in their written agreements must, of course, be considered, but the above cases also held that parol evidence may be heard to determine the real character of the transaction. Evidence as to what the parties have actually done in interpreting their agreements is to be specifically noted, for as the Supreme Court said in *Insurance Co.* v. *Dutcher,* 95 U. S. 269, 273:

> The practical interpretation of an agreement by a party to it is always a consideration of great weight. * * * There is no surer way to find out what parties meant than to see what they have done. Self-interest stimulates the mind to activity and sharpens its perspicacity.

This rule of law was also fully discussed in *Campbell* v. *Dearborn,* 109 Mass. 130. The court there referred to *Russell* v. *Southard, supra,* and commented on the doctrine as set forth in that case as follows (pp. 140, 141):

> The decisions in the federal courts go to the full extent of affording relief, even

in the absence of proof of express deceit or fraudulent purpose at the time of taking the deed, and although the instrument of defeasance "be omitted by design upon mutual confidence between the parties. * * *

This doctrine is analogous, if not identical with that which has so frequently been acted upon as to have become a general if not universal rule, in regard to conveyances of land where provision for reconveyance is made in the same or some contemporaneous instrument. In such cases, however carefully and explicitly the writings are made to set forth a sale with an agreement for repurchase, and to cut off and renounce all right of redemption or reconveyance otherwise, most courts have allowed parol evidence of the real nature of the transaction to be given, and, upon proof that the transaction was really and essentially upon the footing of a loan of money, or an advance for the accommodation of the grantor have construed the instruments as constituting a mortgage; holding that any clause or stipulation therein, which purports to deprive the borrower of his equitable rights of redemption, is oppression, against the policy of the law, and to be set aside by the courts as void.

These general principles of law in regard to the interpretation of agreements are in accord with the well established rule of tax law that the substance, not the form, of a transaction should govern and that a transaction may not be divided into parts in order to avoid the tax which would otherwise

be due. *Weiss* v. *Stearn,* 265 U. S. 242, 254; *First Seattle D. H. Nat. Bank* v. *Commissioner,* 77 F. (2d) 45 (C. C. A. 9th); *San Joaquin Fruit & Inv. Co.* v. *Commissioner,* 77 F. (2d) 723 (C. C. A. 9th).

So it is our contention that each sale and its contemporaneous repurchase agreement was a part of the same transaction and must be considered together and that actually such transactions are loans. As commonly defined, the word "loan" implies money advanced and an obligation to pay back. The word "sale" means an absolute transfer of property or something of value from one person to another for a valuable consideration. *Alworth-Washburn Co.* v. *Helvering,* 67 F. (2d) 694, 696 (App. D. C.); *Omaha Nat. Bank* v. *Mutual Ben. Life Ins. Co.,* 81 Fed. 935, 939 (N. J.); *In re Grand Union Co.,* 219 Fed. 353, 366 (C. C. A. 2d). As to the difference between a sale and a loan, it was stated in *Robinson* v. *Farrelly, supra* (p. 477):

> If the purchaser retain the right to demand the money of the vendor, notwithstanding his purchase, a debt is then due from the vendor to him, and the existence of this debt within itself shows that the conveyance is a mere security for its payment.

A further distinction was pointed out in *Campbell* v. *Dearborn, supra,* in which it was said that if the purchaser does not take the risk of the subject of the contract upon himself but takes security for repayment of the principle, there has been no sale.

Applying these tests to the instant case, it seems clear that loans were made by the respondent. In every instance, when a bill of sale was given a repurchase agreement also was executed (R. 33, 57–60). The latter agreement fixed the price for the repurchase by the dealer, R. H. Moulton & Company, at exactly the same figure as that given by the respondent on the "sale" of the bonds (R. 59–60). The respondent's vice president testified that these agreed prices were about one to five per-cent less than the market price (R. 78). As it is not the custom of bankers or other business men to sell property at less than its market price, the fact that the parties here adopted such prices is a strong indication that they intended to make a loan. Inadequacy of consideration has repeatedly been held to be evidence of a loan. *White* v. *Redenbaugh,* 41 Ind. App. 580; Jones on Mortgages (8th Ed.), Sec. 326.

The promise of R. H. Moulton & Company to repurchase the bonds was absolute and not optional. Each agreement stated that that company "agrees to buy the following bonds" and "agrees to pay on or before ninety days from date hereof" (R. 59). In discussing this promise the Board referred (R. 39) to it as the dealer's privilege to repurchase but such language is misleading. The dealer's position here is in no material sense different from that of a mortgagor. If a mortgagor does not pay back the loan, he loses his property and so would the dealer

here if it had not "repurchased." A mortgagor, as well as this dealer, might decide not to repay the money advanced but in either case there would be a default. Default is defined as an omission to perform an agreement. Black's Law Dictionary, 3rd Ed. Thus it is clear that default is something different from a failure to exercise an option or to take advantage of a privilege. This was understood by the parties here for in referring to the possibility of the dealer's failure to perform, the repurchase agreements used the word "default" (R. 59). So it must be assumed that the dealer had an absolute obligation to perform, that is, a duty to pay back the money advanced to it by the respondent and such duty is inconsistent with the idea of a sale. That the dealer understood its obligation as we have stated it is clearly indicated by the testimony of V. E. Breeden, vice president of R. H. Moulton & Company, who said (R. 84):

> These repurchase agreements were a definite commitment to repurchase at or before the expiration of a certain number of days. None of them were ever allowed to expire without completing the repurchase. That would be a violation of our contract.

We think that the Board was also wrong in construing the rights of the respondent under these repurchase agreements. The Board stated (R. 39) that at any time the respondent needed money it had the right to tender bonds it wished to sell, first to R. H. Moulton & Company, and then to anyone

else who would buy. Thus the Board concluded that such a right of alienation indicated ownership, but we do not agree that it could sell the bonds at any time.

As indicated above, these repurchase agreements (R. 59–60) first provide that the buyer (otherwise referred to herein as the dealer) may have ninety days in which to pay the purchase price. The agreements next state that the respondent "hereby agrees on tender of said purchase price of such bonds and interest as aforesaid to deliver to R. H. MOULTON & COMPANY or its nominee, the bonds as above, at any time hereafter, prior to any default on the part of the Buyer." In the next paragraph it is provided that in the event of any failure on the part of the dealer to accept and pay for the bonds when tendered, the respondent may sell to third parties. Obviously, under these provisions, there could be no default on the part of the dealer until after ninety days. This being so there could be no failure on the part of the dealer within the meaning of the last provision just referred to until after the lapse of ninety days and so the respondent could not legally sell to third parties before the end of that period. If this is not so and the respondent could sell at any time, as the Board held, then part of the agreement is necessarily meaningless. But we do not think that it is, or that its provisions are inconsistent. Instead, we think it is clear that the respondent was under an

obligation to hold the bonds until the end of ninety days or default by the dealer. Thus, the respondent could not dispose of the bonds as an owner could.

The right of free alienation is of course the most important attribute of ownership. The dealer had such right all of the time, subject, of course, to the payment of the agreed price, which, up to ninety days, could be paid to the respondent at any time the dealer wished to do so. As a matter of fact the dealer frequently exercised its right to sell while the bonds were in the possession of respondent and would then demand their return in order to turn them over to its customer (R. 82–83). The dealer had this right of alienation to the exclusion of all others and the final test of ownership is the right to exclude all others. *Computing Scale Co.* v. *Toledo Computing Scale Co.*, 279 Fed. 648, 671 (C. C. A. 7th), certiorari denied, 257 U. S. 657.

While the respondent could not sell the bonds during the ninety days the repurchase agreements were in effect, it should be noted on the other hand that, at the end of such time, the respondent had a right to demand its money from the dealer and upon its failure to pay could get it back by selling to third parties. So it is evident that there was a debt here within the holding of *Robinson* v. *Farrelly, supra,* in which it was said that the retention by a purchaser of the right to demand money is convincing evidence of the existence of a debt.

In this connection there is a further significant fact to be noted. If the respondent had sold to third parties and had not realized the amount which it had paid the dealer in the beginning, these agreements required the latter to make good the loss. Certainly this provision is not consistent with a sale. If the respondent had purchased outright, it is difficult to understand why the dealer would be concerned in a sale by the respondent to a third party to the extent that it would guarantee the respondent against loss. In this connection it must not be forgotten that the dealer did not receive market price from the respondent in the beginning and since there is nothing to indicate that it had not paid market price, apparently it had suffered a loss in letting the respondent take them at the lower figure. So to construe these transactions as sales would mean that the dealer was willing in the first instance to make an outright sale of its bonds at a loss and then after it was no longer interested in them was still willing to pay any loss which the respondent might have on sales to a third party. The mere statement of such a view of the matter is enough to show that it could not have been what the parties intended here. Instead, the respondent simply was unwilling to take the risk of the contract but required security and this, as was held in *Campbell* v. *Dearborn, supra,* prevents these transactions from being outright sales.

The Board referred to the failure of the repurchase agreements to require the respondent to account to Moulton & Company for any profit which the former might realize on a sale of the bonds to third parties. It called attention to Section 3008 of Deering's California Civil Code (1931 Ed.),[1] providing that an accounting must be made for any surplus from the sale of collateral or under a chattel mortgage. In reply we think it sufficient to say that, assuming Section 3008 to be applicable to transactions like those here, Section 3268 of the same Code allows parties to contracts to waive certain provisions of the Code, including the Section just referred to, and it is clear that there is a waiver here since the agreements allow the respondent to sell to third parties "for the best price obtainable" (R. 60).

Another provision in the repurchase agreements which should be noted is that stating that maturing coupons are to be the property of the respondent (R. 59). If the latter had become the owner of the bonds when the so-called "sales" were made, then it would have become entitled to interest therefrom and no mention of the fact would have been necessary. The fact that the parties included the provision is an indication, we think, that they thought the interest would still belong to the dealer and that they wished it to be used as payment by the dealer for the money advanced by the respondent.

[1] The Board referred to the Code of Civil Procedure but this matter appears in the Civil Code cited above.

As to this, it may be urged that inasmuch as the respondent held the coupons, and collected this bond interest, the parties did not intend that it be treated as an interest payment from the dealer but we think that the parties settled on this as the payment in their negotiations. This is shown in the testimony of the vice president of R. H. Moulton & Company when he said (R. 83), "the prices on these repurchase agreements were settled through negotiations between the bankers and ourselves at what they felt was the current rate, or the rate in which they might be interested in making the purchase." During these negotiations, the parties obviously considered what compensation should be paid to the respondent for advancing the money and as indicated elsewhere the parties decided that it would be satisfactory to adopt the same rate of interest as paid by the bonds. Also it appears that the parties decided that it would be a convenient method of payment to allow the respondent to cash the coupons attached to the bonds held by it as security.

However, even if the provision as to interest is construed in a way most favorable to the respondent, it must be admitted that such provision raises a doubt as to the parties' intention and because of this and other doubts raised by the agreements, parol evidence should be considered. Some of the parol evidence has already been referred to but no mention has as yet been made of the reason why

the respondent used this method of advancing money rather than ordinary loans. The Board stated (R. 43) that "the record shows that no special considerations or conditions other than those set forth in the contract motivated the actions of the parties." We do not agree. There was a special reason and this was that the bank had more funds than it could legally invest in regular loans and used so-called 'sales" and "repurchases" to get around this difficulty imposed by the law.

The respondent's vice president, testifying as to this, said that his bank could place more funds with a customer by the financing method used here than by loans because banks were limited by state and national law as to the amount which they could lend to any customer, the limit being ten percent of the bank's capital and surplus, and that his bank could buy two million dollars worth of these securities while it could legally lend only a million and a half, that this method of advancing money was first adopted about 1924 or 1925, and that it was advantageous because it put the bank's clients in possession of more money than the bank could lend (R. 71, 73). This statement is also borne out by the testimony of the vice president of R. H. Moulton & Company, the other party to these repurchase agreements. This witness stated that his company always needed money since its inventory was much larger than its capital (R. 80), that it was necessary to get such money either by borrow-

ing or "through the sale of bonds, *the temporary sale* and repurchase of the bonds" (R. 80), that ninety-nine percent of its business was done on the latter plan (R. 80), that it adopted this method because there was no limitation on the amount of bonds a bank could buy (R. 83), that a bank is limited in making loans on collateral to ten percent of its capital and surplus (R. 84), that if his company had conducted its business "through collateral loans under the rules, national and state, governing banking practice, we would have been required to supply a margin for our collateral loan" (R. 87), and that if his company had "been borrowing on collateral we would have been subject to the limitations placed by the National Bank Act, or the National Act on State banks, that only ten percent of the capital and surplus of the bank would be advanced to any particular individual" (R. 87–88).

This testimony shows conclusively that there was a special motive for using the plan of repurchase agreements, but in effect loans were made and that was what the parties intended. The last witness referred to above said as much when he testified that "The bank was really carrying our inventory for us" (R. 83), and when he explained that these bonds were carried on the books of R. H. Moulton & Company as assets and the liability to repurchase as a liability (R. 92).

The same witness also referred to prior negotiations which he had had with the respondent with

the view to seeing if he could get the necessary funds advanced with which to buy bonds for his company and to determine the rates for such advances (R. 81, 83). He also stated that very frequently the repurchase agreements with the bank were made contemporaneously with the purchase of bonds by his company and if he did not make prior arrangements for funds it was because he was in a position to know there was a constant market with the banks for this type of repurchase agreement and that he could secure the funds needed (R. 81). Thus the witness showed in getting the money needed for his company's business he acted as any other business man who is seeking a loan.

A transaction similar to those here was involved in *First Nat. Bank in Wichita* v. *Commissioner,* 57 F. (2d) 7 (C. C. A. 10th), certiorari denied, 287 U. S. 636, and the court there held it was a loan although the parties themselves had called it a sale with a right to repurchase and the Comptroller of the Currency had reached the same conclusion. As the Board has pointed out (R. 39–41) the terms of the agreement in that case were somewhat different from those here but it is significant that the Comptroller of the Currency in ruling on the nature of such transactions prior to the presentation of the question to the court, said in a letter to one of the parties that the agreement could be approved as a sale but explained that he would have

decided to treat it as a loan subject to the limitations in Section 5200, Revised Statutes, *if the original vendor could have been compelled to repurchase the bonds.* Here the respondent had a right which was equivalent to compelling repurchase for if the dealer had refused to repurchase, the former could have recovered its money through sales to third parties and in case of loss could have collected the difference from the dealer. Thus under the Comptroller's ruling the transactions here should be treated as loans.

It is the policy of the law to prohibit the conversion of a conveyance for security into a sale (*Conway* v. *Alexander,* 7 Cranch 217, 236) and such policy of the law may be invoked here by the petitioner as well as in a case between parties to such transactions. In cases involving the Government's revenues, the Government is entitled to have a consideration given to all pertinent facts which will show what has actually transpired. Especially is this true in cases involving a claim to a tax exemption. Exemptions are never to be lightly inferred. Instead all doubts must be resolved against the one claiming the exemption. Thus to avail oneself of an exemption, the claim thereto must be clearly defined and based on plain language. *Pacific Co.* v. *Johnson,* 285 U. S. 480, 491; *J. W. Perry Co.* v. *Norfolk,* 220 U. S. 472; *Bank of Commerce* v. *Tennessee,* 161 U. S. 134, 146.

When viewed in the light of all the evidence and the principles of law discussed herein, we think it is clear that the respondent did not receive the interest here in question as owner of the bonds and is not entitled to the claimed exemption.

CONCLUSION

The decision of the Board of Tax Appeals is erroneous and should be reversed.

Respectfully submitted.

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